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January 30, 2006

Chairman Jeff Hatch-Miller
Commissioner William A. Mundell
Commissioner Marc Spitzer
Commissioner Mike Gleason

Re: Further action to combat hedge funds operating illegally in Arizona in light of the Mathon Fund, LLC case.

Dear Colleagues:

In recent months the risks and potential abuses associated with small, unregistered hedge funds have been highlighted by the spectacular and high profile failure of several of these investment vehicles.

Most notably, the Commission has alleged in a pending action before the Maricopa County Superior Court that Arizonans have been victimized by the collapse of the Mathon Fund, LLC and related entities, a constellation of small hedge funds whose manager, Mathon Management Company, LLC, took in more than \$80 million from more than 200 investors. Characterized as a pure Ponzi scheme by the conservator in the case, at the end the Mathon Fund had only \$310,824 remaining in its bank account. Some hedge funds in other states have come under fire for making exaggerated promises, posting poor returns while fund managers pay themselves exorbitant fees.¹

Hedge funds are private in nature and have been structured in a way to take advantage of federal and state exemptions that make it difficult to say just how many of them are currently operating in Arizona. Some hedge fund exemptions offered at the federal level do not require any filings at all. And under federal Rule 506, hedge funds may receive an exemption from substantive registration. Funds that receive this exemption at the federal level need only issue a notice of the offering with the Commission. However, pursuant to Arizona law, any person with a place of business in Arizona who advises a hedge fund must register as an investment adviser at the Commission, unless the person is already registered as a dealer or salesman.

To date, nine individuals have registered as investment advisers to hedge funds in Arizona. In December, the Securities Division began tracking notices filed by Arizona-based issuers that are

¹ See the attached articles on hedge funds from US News and World Report and the Rocky Mountain News. Additionally, Arizona was touched by the Bayou hedge fund case when monies believed to be related to that failed hedge fund were seized by the Arizona Attorney General.

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selling interests in hedge funds under Rule 506 to ensure that those directing these funds are properly registered as investment advisers. Since December, two issuers selling interests under Federal Rule 506 described their business as a hedge fund or pooled investment vehicle.

I believe that the Commission should consider stepping up our efforts to identify these hedge funds, educate investors about their risks, and root out those funds that are operating illegally.

Among other steps I believe we should take are:

1. Identify all existing hedge funds and target each one individually to determine whether they are operating properly.
2. Increase our outreach to the public on these funds with investment advisories designed to educate investors about the risks of small hedge funds and how to identify funds that are not operating legally.
3. Promulgate a message to the investment community to warn them of the need to register with the Commission and/or the SEC.
4. Hold a workshop to determine whether any further steps can or should be taken against illegal hedge funds, including pursuing enforcement and legislative initiatives as appropriate.

I welcome your thoughts on these ideas and look forward to discussing them at an upcoming Staff meeting.

Sincerely,



Kris Mayes
Commissioner

Cc: Matt Neubert
Brian McNeil
Heather Murphy

Rocky Mountain News

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Paton: Hedge funds drawing eye of regulators

December 7, 2005



Regulators in Colorado are cracking down on hedge funds, hunting down money managers who operate without a license, inflate their returns or use exclamation points and "guarantees" to lure money.

The popularity of hedge funds has risen - along with the number of disreputable people trying to capitalize on the hype. While Colorado is hardly a hedge fund haven like Greenwich, Conn., its own industry has grown in recent years.

The Colorado Division of Securities, led by Commissioner Fred Joseph and his deputy, Gerald Rome, leveled its first two cases against hedge funds in the past year and played a role in a third investigation.

The latest move was a lawsuit filed late last month against Ark Capital Management, a hedge fund firm based most recently in Parker.

The cases have a theme. Typically the hedge fund managers lack a license in the state, exaggerate their investment gains and use investors' money to buy things for themselves, the state said.

Investors, humbled during the bear market of late 2000 to 2002 and looking for alternative places to park their cash in recent years, have turned eagerly to hedge funds. The funds use an array of strategies typically off limits to their mutual fund cousins, such as selling stocks short on a bet they will fall and using borrowed money.

"Retail investors were reading in *The Wall Street Journal* that hedge funds were the only investment vehicles with big returns," Rome said.

Once reserved for the super-rich, hedge funds have gone mainstream. The state regulator estimated late last year that between 60 and 80 companies could be operating hedge funds in Colorado.

Most hedge funds are totally above-board, smart options for the right investor. A few, however, are bad apples.

The securities division plans to release an "investor alert," warning Coloradans to use caution when dealing with products calling themselves hedge funds, Joseph said.

First, investors ought to do some digging, Joseph said. If the hedge fund manager lacks a license in Colorado, that's reason to run. Both the Securities and Exchange Commission and the state's division of securities - www.dora.state.co.us/securities - can quickly answer that question.

In the case of Ark Capital, the defendants said the hedge fund had risen 88 percent between June 2000, its inception, and Dec. 18, 2004. But the state says it had losses of about \$441,000 during that time. The fund also "guaranteed 18 percent" returns, according to the lawsuit, which names Steven Donnellan, of Parker; Philip Candy of Michigan; and Todd Keizer of Arizona as defendants.

Donnellan's lawyer, former U.S. Attorney Mike Norton, said he hasn't seen the lawsuit but that his client will "fully cooperate with the investigation." The two other men did not comment.

The defendants allegedly failed to disclose they "diverted" investor money to buy a \$550,000 home in Parker and a luxury car.

Joseph's office helped the SEC in another case, a lawsuit involving a Castle Rock money manager, Joseph Ferona, whose pitch was the "Hedge Fund of Colorado, The New Age of Investing!"

Whether they're in Douglas, Dolores or Denver, hedge funds can expect a regulatory knock at the door.

James Paton and David Milstead take turns writing Up and Down 17th Street. Contact Paton at patonj@RockyMountainNews.com or 303-892-2544.

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Hedge Funds Get Clipped

Slim gains and scandals turn off investors

By Kit R. Roane

Think hedge funds mint money? Consider this: The Standard & Poor's hedge fund index posted gains of just over 2.4 percent in 2005--after meager gains of 3.6 percent in 2004--or about half the performance of the S&P 500.

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That track record hasn't hurt the earnings of the average hedge fund manager, who took home about \$1.2 million in 2004. But with the number of hedge funds--thinly regulated investment pools for the well-to-do--having mushroomed from a few hundred to more than 8,000 worldwide, with combined assets now around the \$1 trillion mark, many investors are finding that storied hedge fund edge elusive. It's pretty hard, after all, to make the case that all 8,000 funds are being run by the best and the brightest. And in such a crowded field, many of the tactics that have made hedge funds so profitable in the past are oversubscribed.

Compounding such troubles is the fact that even high-profile funds have gotten caught up in legal and regulatory probes. Some pension funds are grumbling about the high fees that funds charge. And new research suggests fund returns were never quite so good as they

first appeared. It's enough to leave some former hedge fund bulls to conclude that the party's over--for good. "Our day has come and gone," complains Joseph Aaron, whose California investment firm Wood, Hat & Silver has put money in hedge funds. "There's no edge left. The returns are just not there, and they aren't coming back."

In the dark. Most retail investors have only a vague idea of what hedge funds do to make money, or why hedge fund managers are able to charge fees that would be seen as obscene in any mutual fund. What they know is that hedge funds are hot and that they wield enormous power over the financial markets and the companies whose stocks they invest in.

They aren't totally off the mark. But the general rule of thumb is that hedge fund managers make sizable salaries by pledging to make money for their investors even when the stock market is tanking and the bond market is in the doldrums. They promise an absolute return and don't mind betting against the stock market, leveraging investor assets, or delving into all sorts of esoteric derivatives and volatile markets to do so. And over the past few years, at least until recently,

many hedge funds have done well by the exclusive investors who often plop down minimum investments of \$250,000 to \$1 million to fund these financial excursions. Many received high double-digit returns.

Some of the old guard may continue to do well by their investors. But Aaron, who is pulling back from the sector, is not the only hedge fund watcher to be concerned that many others won't. Hedge fund inflows have dropped to about half the level of 2004. Withdrawals have also risen, as have the number of funds not reporting their results in 2005. And more bad news could be on the way.

William Wechsler, a vice president with financial services consultants Greenwich Associates, points out that hedge funds have flourished in a protracted investment environment where investors were confronted by both low interest rates and sluggish equity markets. "But that is a very unusual set of circumstances," he says.

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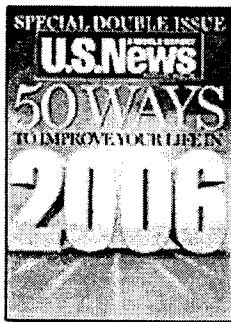
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Wechsler says that hedge funds will go through a cycle similar to the one they endured after becoming a favorite of investors in the late 1970s. When the sweet spot disappeared, only a few hedge funds remained. The rest were forced to shutter. Another wave of hedge fund consolidation could be on the horizon, with the industry contracting, then bifurcating with a few supersize hedge fund companies rising out of the ashes and the rest of the survivors becoming small boutiques specializing in very specific styles of investment. "History shows that you can always find somebody to give you money," says Wechsler, "but it is going to get more difficult for hedge funds."

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While few have imploded with the ferocity or fanfare of Long Term Capital Management, whose highly leveraged and badly hedged bets in emerging markets ended in a \$3.5 billion bailout in 1998, they do continue to fail or close at a regular clip. Researchers studying Tremont Capital Management's database have estimated that 10 percent of all hedge funds close each year and that most last only a few years.

Closing time. Securities and Exchange Commissioner Roel Campos noted worriedly in a speech to the Managed Funds Association in London last July that some of those closing shop are pretty established funds. Among them, EBF & Associates Lakeshore International fund, which had \$669 million under its wing and, as Campos noted, was "among the oldest" and among the most successful funds that specialized in convertible bonds.

Hedge funds were the subject of more than 38 SEC enforcement decisions from January 2004 to the middle of October 2005, the latest date for which figures are available. That is more than half the total number of enforcement actions undertaken against hedge funds since the beginning of 1999, SEC documents show.

Further scrutiny will follow in February when new SEC accounting and disclosure guidelines take effect, although the regulations may be struck down soon afterward. They are currently the subject of a lawsuit brought by Phillip Goldstein, manager of Opportunity Partners in New York. Goldstein asserts that the SEC has overstepped its authority; and in questioning the SEC, two of three U.S. appeals court judges have signaled they may agree. Their opinion is expected within

the next few months.

Either way, hedge funds have a growing public-relations problem on their hands. Some notable cases:

A few days before Christmas, the SEC accused the head trader and the manager of Montvale, N.J., hedge fund HMC International of operating a "Ponzi scheme" that looted investors of \$5.2 million. Mark Schonfeld, regional director of the SEC's Northeast office, said the hedge fund was "pure fiction," adding that the defendants "led lifestyles of the rich and famous at the expense of their investors." One defendant has claimed he was among those swindled. The other's lawyer told *U.S. News* he had no comment.

Also in December, hedge funds controlled by Millennium Management and four of the firm's executives paid \$180 million to settle regulatory charges that they made more than 76,000 illegal market-timing trades in and out of mutual funds. The trades, which regulators say amounted to some \$52 billion and netted tens of millions in profits over several years, tend to raise mutual fund expenses and dampen profits for other shareholders.

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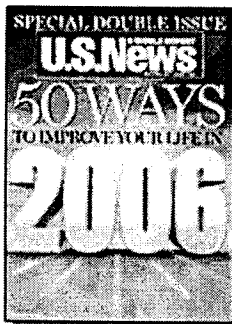
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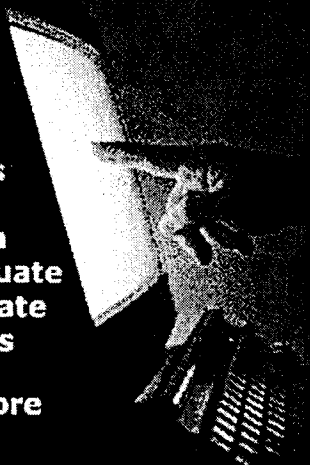
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In October, the SEC alleged that John Whittier, principal manager of Wood River Partners, misrepresented to investors that he was creating a broadly diversified portfolio and that the fund would be overseen by an auditor. Instead, the SEC alleges, Whittier conducted no audits and amassed a position in one small-cap stock, Endwave Corp., equal to 65 percent of the entire \$265 million that the fund claimed to have under management. Through his lawyer, Whittier said that he always worked in the best interests of his shareholders.

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The SEC filed a complaint in November against Mark Conway, founder of the \$43 million hedge fund Ground-swell Partners, alleging that the well-known trader had defrauded clients by hiding millions in losses and misleading them about the assets in its fund. The fund, the SEC says, now holds only \$14 million. Conway's lawyer did not return calls.

In September, the once highflying Bayou Group's founder, Samuel Israel III, and chief financial officer, Daniel Marino, both pleaded guilty to mail and investment adviser fraud charges. The fund took in more than \$450 million from investors, but so far investigators have been able to find only a portion, which had been briefly stashed in an Arizona account.

New York University history major Hakan Yalincak is perhaps the most interesting

character to face fraud accusations this year. Federal prosecutors say Yalincak and his mother, Ayferafet Yalincak, convinced investors they were buying into a group of hedge funds and Yalincak-controlled companies. But the Greenwich, Conn.-based adviser allegedly spent about \$7 million of his investors' money on items like Tiffany diamonds and a new Porsche. Prosecutors say Yalincak also used the money to increase his renown, donating \$1.25 million of investors' money to NYU, then promising about \$20 million more. He intended to have the university name several buildings in the family's honor. Both Yalincak and his mother, who has a previous

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conviction for posing as a doctor, have pleaded not guilty to all charges. Their trials are now set for April.

Running scared. Andrew Sterge, who runs AJ Sterge Investment Strategies, a hedge fund specializing in derivatives based on insurance risk, says that if the number of investigations continues to climb, investors may be scared off from investing in the sector as a whole and "invest in a stock fund or an index fund instead."

No matter what, hedge funds are likely to face increased scrutiny in the form of regulatory oversight. That could hasten their undoing, as exemption from tight regulation has long been the funds' calling card. Alfred Winslow Jones, a sociologist, created the first hedge fund in 1949 after researching a business article and finding out some traders were doing a lot more than buying and holding. He put their ideas together in a limited partnership to exempt it from normal regulatory control.

The SEC is among a group of regulators now flexing their muscle. The International Organization of Securities Commissions, which monitors global finance, said in October that it is considering new hedge fund regulations. And Connecticut, which is home to the second-highest concentration of hedge funds in the country after New York, is studying what regulations it might impose. "The absence of federal regulation so far may open doors that would otherwise be shut," says Connecticut Attorney General Richard Blumenthal. "The idea that the investors are all wealthy and sophisticated and can protect themselves is no longer as true as it once was."

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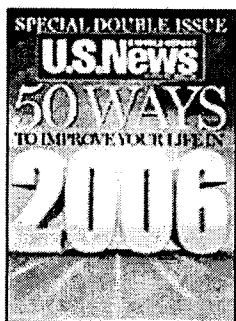
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In fact, retail investors can gain easy, if costly, exposure to hedge funds by investing in "funds of hedge funds," some of which require only \$25,000 in initial assets. The practice has caused enough concern that David Swensen, chief investment officer for Yale University and a longtime user of hedge funds in managing Yale's \$14 billion investment portfolio, recently called for the elimination of such hedge fund baskets in a *New York Times* opinion piece. He also goaded regulators to "prohibit unsophisticated players" from investing in hedge funds at all.

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Some investors may not even be aware that their money is already tied up in a hedge fund. Institutional firms that manage small investors' money, such as pension funds, are becoming increasingly big users of hedge funds. The California Public Employees' Retirement System, the nation's largest pension plan, has about \$1.2 billion of its \$200 billion portfolio invested in hedge funds and plans to nearly double that stake soon to increase returns amid an increase in expected retirements. Charitable money is ending up there, too. The Jewish Federation of Metropolitan Chicago, for instance, says it lost \$4 million in the Bayou implosion.

Universities, such as Harvard, and religious institutions, like the Roman Catholic Church, among others, are hedge fund investors. Although private investors and money managers may be cooling to the investment vehicle, U.S. institutional investors, such as

pension funds, are expected to increase their stake in hedge funds to \$300 billion by the end of 2008, a 400 percent increase from 2004.

Maybe all these hedge fund investors will make a killing. It's not that there aren't opportunities left. Hedge funds are finding an increasingly wide array of investments to dip into, from buying distressed debt and emerging market assets to taking positions in complicated and sometimes illiquid derivative products. Some funds are attempting to tackle the competition, the risk, and

the lackluster returns by diversifying into several strategies at once. Others are looking for the next big thing, like debt instruments tied to lawsuit payouts, or life-insurance financing, or catastrophe bonds, also known as CAT bonds, which are a form of insurance for insurance companies if their losses from a hurricane or other natural disaster exceed a prescribed limit.

But successful strategies draw a crowd, and none are foolproof--just ask the hedge funds that got burned on CAT bonds when Katrina hit. And there is no telling whether most or even many of the 8,000 hedge fund managers out there are nimble enough to stay ahead of the curve--or whether investors can find the ones who truly are.

In the long run, hedge funds are likely to prosper only as long as their returns beat the market over time, and Aaron for one is unwilling to take those odds. "You're either in with one of the truly great managers of the world or you're not, and if you're not in with one by now, they won't let you in because they don't need your money," he says. What's left? "Pretty mediocre pickings."

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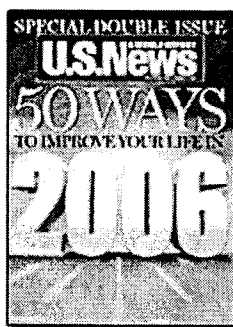
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